

STATE OF NEW YORK

DIVISION OF TAX APPEALS

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| In the Matter of the Petition | : | |
| of | : | |
| THE RACAL CORPORATION | : | DETERMINATION |
| AND DECCA ELECTRONICS, INC. | : | DTA NO. 807361 |
| | : | |
| for Redetermination of a Deficiency or for | : | |
| Refund of Corporation Franchise Tax under | : | |
| Article 9-A of the Tax Law for the Fiscal Years | : | |
| Ended March 31, 1985 through March 31, 1987. | : | |

Petitioners, The Racal Corporation and Decca Electronics, Inc., 1000 Corporate Drive, Suite 400, Ft. Lauderdale, Florida 33334, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal years ended March 31, 1985 through March 31, 1987.

On June 7, 1991 and June 10, 1991, respectively, petitioners by their representative, Henry B. Miller, Esq., and the Division of Taxation by William F. Collins, Esq. (James Della Porta, Esq., of counsel) consented to have the instant controversy determined on submission without hearing. Documentary evidence was submitted by petitioners on July 23, 1991. Petitioners submitted a brief on July 30, 1991. The Division of Taxation submitted a brief on August 30, 1991. Petitioners submitted a reply brief on September 27, 1991. After review of the entire record, Thomas C. Sacca, Administrative Law Judge, renders the following determination.

ISSUE

Whether petitioners are entitled to exclude from entire net income interest income received from second tier subsidiaries.

FINDINGS OF FACT

As part of the submission of this matter, the duly authorized representatives of the parties entered into a stipulation of facts. The stipulation is set forth hereinafter in paragraphs "1"

through "21", with all references to exhibits omitted.

Stipulated Facts

The Racal Corporation ("TRC") (formerly Racal Holdings, Inc.) is a Delaware corporation formed in 1977 and was the principal holding company for the Racal Electronics, Inc., U.S. affiliated group of companies ("REI") during the audit years, fiscal years ended March 31, 1985 through March 31, 1987. REI has owned 100% of TRC's issued and outstanding capital stock from 1977 to the present. TRC maintained a New York City office and filed New York tax returns during the audit years.

Decca Electronics, Inc. ("DEI") is a New York corporation organized in 1946. TRC has owned 100% of DEI's issued and outstanding capital stock since 1982. DEI was an inactive corporate shell during the audit years. DEI's only business activities were the accrual on loans to its subsidiaries and expenses related to its sole employee who managed the holding company's books and records. DEI filed New York corporation franchise tax returns during the fiscal years 1985, 1986 and 1987.

Decca Navigator Systems, Inc. ("DNSI") is a Delaware corporation organized in 1946. DEI owned all of DNSI's issued and outstanding voting stock during the fiscal years 1985, 1986 and 1987. During these years, DNSI was an inactive shell company that conducted no business during the audit years. The only business activity of this "paper" entity was the accrual of interest on loans from DEI entered into many years earlier and payment of other minor expenses allocated to them. DNSI was not subject to New York taxes nor did it file New York tax returns during the years at issue.

Decca Survey Systems, Inc., subsequently Racal Decca Survey, Inc. ("RDSI"), is a Delaware corporation formed in 1965. DNSI owned all of RDSI's issued and outstanding voting stock during the fiscal years 1985, 1986 and 1987. RDSI supplied survey equipment and rendered services to oil companies in Louisiana and Texas. Its headquarters are in Houston, Texas. RDSI was not subject to New York taxes nor did it file New York tax returns during the audit years.

In April 1980, REI's U.K. parent, Racal Electronics, PLC ("Racal"), acquired Decca Ltd. ("Decca") and its U.S. subsidiaries including DEI, DNSI and RDSI. Decca was a publicly-held U.K. company in the recording and electronics businesses prior to its acquisition by Racal.

Prior to Racal's acquisition in 1980, DEI, then London Records, operated the Decca Group's U.S. record business and served as the holding company and finance company for Decca's U.S. Group. Immediately prior to Decca's acquisition, Decca sold the record business and changed the name of the company to Decca Electronics, Inc. After Racal acquired Decca, DEI made no further loans to DNSI, RDSI or any of its other subsidiaries.

DNSI paid DEI \$3,759,450 in interest during fiscal year 1985, \$3,817,088 in interest during fiscal year 1986, and \$4,122,456 in interest during fiscal year 1987 on DNSI's outstanding loans with DEI.

RDSI paid DEI \$1,405,974 in interest during fiscal year 1985, \$1,456,882 in interest during fiscal year 1986, and \$1,557,946 in interest during fiscal year 1987 on RDSI's outstanding loans with DEI.

TRC/DEI had absolute control over the election and removal of DNSI and RDSI officers and directors during the fiscal years 1985, 1986 and 1987.

TRC/DEI had absolute control over all DNSI and RDSI operational, tax and financial matters during fiscal years 1985, 1986 and 1987. DNSI and RDSI officers and directors did not have the power or authority to act independently of TRC/DEI during the audit years.

TRC/DEI had the absolute power to cause dividends to be declared and paid from DNSI and RDSI during the fiscal years 1985, 1986 and 1987.

TRC/DEI had the absolute power to dictate the management and policies of DNSI and RDSI during the fiscal years 1985, 1986 and 1987.

TRC/DEI had the absolute right to sell or pledge all of DNSI's and RDSI's stock during the audit years.

TRC/DEI had the absolute power to maintain a shareholder derivative action during the audit years.

TRC/DEI have treated DNSI and RDSI as subsidiaries for all purposes, including but not limited to, the calculation and reporting of Federal income and State franchise taxes.

RDSI held itself out as a TRC/DEI subsidiary.

TRC, DEI, DNSI, and RDSI had common officers and directors during the fiscal years 1985, 1986 and 1987.

During the fiscal years 1985, 1986 and 1987, TRC, DEI, DNSI, and RDSI filed consolidated Federal tax returns with the REI affiliated group. RDSI and DNSI income and expenses were consolidated into and included with REI's audited financial statements in accordance with generally accepted accounting treatment of subsidiaries.

The New York Department of Taxation and Finance ("New York") sent DEI and TRC proposed adjustments to their 1985, 1986 and 1987 New York corporation franchise tax liability on April 9, 1989 in the amount of \$585,364 and \$16,492, respectively.

New York sent DEI and TRC notices of deficiency under Article 9-A of the Tax Law asserting a total of \$614,969 in tax deficiencies for the fiscal years 1985, 1986 and 1987.

New York auditors filed an audit report regarding the alleged 1985, 1986 and 1987 tax deficiencies by DEI and TRC in August 1989.

Additional Finding of Fact

The Division adjusted the entire net income of petitioners by adding back to entire net income the interest payments received by DEI from RDSI, which had been deducted by DEI as interest income from subsidiary capital.

CONCLUSIONS OF LAW

A. Tax Law § 208(9) provides, in pertinent part, as follows:

"The term 'entire net income' means total net income from all sources...

(a) Entire net income shall not include:

(1) income, gains and losses from subsidiary capital...."

Tax Law §§ 208(3) and 208(4)(a) define "subsidiary" and "subsidiary capital" as follows:

"3. The term 'subsidiary' means a corporation of which over fifty per centum of the number of shares of stock entitling the holders thereof to vote for the election

of directors or trustees is owned by the taxpayer;

4. (a) The term 'subsidiary capital' means investments in the stock of subsidiaries and any indebtedness from subsidiaries..., whether or not evidenced by written instrument, on which interest is not claimed and deducted by the subsidiary for purposes of taxation under article nine-a...of this chapter...."

B. The corporation franchise tax regulations, 20 NYCRR 3-6.2, provide the following definition of the term "subsidiary":

"(a) The term subsidiary means a corporation which is controlled by the taxpayer, by reason of the taxpayer's ownership of more than 50 percent of the total number of the shares of stock of such corporation, issued and outstanding, which entitle the holder of the shares to vote at elections of its directors or trustees. The determination of whether or not particular shares of a corporation's stock entitles the holder of such shares to vote for the election of directors or trustees of the corporation depends on the actual legal situation with respect to voting rights, as it exists from time to time.

* * *

(b) The test of ownership is actual beneficial ownership, rather than mere record title as shown by the stock books of the issuing corporation. A corporation will not be considered to be a subsidiary because more than 50 percent of the shares of its voting stock is registered in the taxpayer's name, unless the taxpayer is the actual beneficial owner of such stock. However, a corporation will not be considered a subsidiary if more than 50 percent of the shares of its voting stock is not registered in the taxpayer's name, unless the taxpayer submits proof that it is the actual beneficial owner of such stock.

* * *

(d) In any case, where the record holder of shares of voting stock of a corporation is not the actual beneficial owner of the stock, or where the right to vote such stock is not possessed by the record holder or by the actual beneficial owner of the stock, a full and complete statement of all relevant facts must be submitted."

Thus, the issue to be addressed is whether petitioners are the beneficial owners of the stock of DNSI and RDSI.

C. Beneficial ownership is marked by command or dominion over the property or the enjoyment of its economic benefits (Yelencsics v. Commissioner, 74 TC 1513, citing Anderson v. Commissioner, 164 F2d 870, affg 5 TC 443; Macon, Dublin & Savannah Railroad Co. v. Commissioner, 40 BTA 1266; Rev Rul 84-79, 1984-1 C.B. 190). In determining beneficial ownership, substance rather than form should control.

The stipulated facts in this matter clearly establish that petitioners were the beneficial

owners of the stock of DNSI and RDSI as they had dominion and command over, and received the economic benefit of, such stock, and thus DNSI and RDSI were subsidiaries of petitioners.

During the audit period, petitioners had absolute control over the election and removal of DNSI and RDSI officers and directors and of DNSI's and RDSI's operational, tax and financial matters. DNSI and RDSI officers and directors did not have the power or authority to act independently of petitioners. Petitioners had the absolute power to cause dividends to be declared and paid from DNSI and RDSI, to dictate the management and policies of DNSI and RDSI and the absolute right to sell or pledge all of DNSI's and RDSI's stock. Petitioners had the absolute power to maintain a shareholder derivative action, which requires an equitable interest in the corporation against which the action is being brought (Business Corporation Law § 626[a]; see, Bernstein v. Polo Fashions, Inc., 55 AD2d 530, 389 NYS2d 368). Petitioners, DNSI and RDSI had common officers and directors and filed consolidated Federal tax returns with the REI affiliated group.

The treatment of DNSI and RDSI as subsidiaries of petitioners is consistent with the filing by petitioners, DNSI and RDSI of consolidated Federal tax returns with the REI affiliated group. An "affiliated group" is defined by Internal Revenue Code § 1504(a)(1) as:

"(A) 1 or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation, but only if --

(B)(i) the common parent owns directly stock meeting the requirements of paragraph (2) in at least 1 of the other includible corporations, and

(ii) stock meeting the requirements of paragraph (2) in each of the includible corporations (except the common parent) is owned directly by 1 or more of the other includible corporations." (Emphasis added.)

Paragraph 2 of Internal Revenue Code § 1504(a) contains the 80 percent voting and value test. The ownership of stock of any corporation meets this test where it possesses at least 80 percent of the total voting power of the stock of such corporation and has a value equal to at least 80 percent of the total value of the stock of such corporation.

The direct ownership requirement of section 1504(a) of the Code is interpreted to mean beneficial ownership (Miami National Bank v. Commissioner, 67 TC 793). The direct

ownership required by the statute is not merely possession of the naked legal title, but beneficial ownership, which carries with it dominion over the property (see, Macon, Dublin & Savannah Railroad Co. v. Commissioner, supra; Rev Rul 84-79, supra). Thus, under the consolidated Federal tax return requirements of the Internal Revenue Code, petitioners had dominion over the stock of DNSI and RDSI.

For the above stated reasons, petitioners were the beneficial owners of the stock of DNSI and RDSI, and DNSI and RDSI were petitioners' subsidiaries within the meaning and intent of Tax Law § 208(3).

D. The franchise tax on banking corporations (Article 32 of the Tax Law) and the regulations promulgated thereunder contain both statutory (section 1450[d]) and regulatory (20 NYCRR 16-2.22) definitions of the term "subsidiary" which are nearly identical to the definitions contained in Article 9-A and its regulations. The franchise tax on banking corporations regulations found at 20 NYCRR 16-2.2, which were promulgated on December 3, 1985, follow a Technical Services Bureau Memorandum issued by the Department of Taxation and Finance on February 15, 1979, and revised on October 19, 1979. The memorandum, in addressing the issue of when a corporation's voting stock is beneficially owned by another corporation, states, as follows:

"Voting stock is beneficially owned when a corporation has actual or beneficial ownership of the voting stock of another corporation. The stockholder has actual ownership when it has the right to vote for the election of directors and the right to receive dividends. The stockholder has beneficial ownership when it owns indirectly and controls the voting stock of another corporation."

The memorandum goes on to describe the term "control" as:

"all cases where one corporation or association possesses, directly or indirectly, the power to direct or cause the direction of the management and policies of another corporation or association, whether through the ownership of voting stock of such corporation or association or the ownership of voting stock of any corporation or association which possesses such power." (TSB-M-79[1]C).

An analysis of the stipulated facts in light of the discussion contained in the Technical Services Bureau Memorandum leads to the same conclusion that DNSI and RDSI were beneficially owned by, and therefore subsidiaries of, petitioners.

E. The State Tax Commission decisions in the Matter of Sears Industries, Inc. (July 26, 1985), Matter of Armour & Company (April 4, 1985) and Matter of Texas Instruments Incorporated (June 27, 1980) are distinguishable. The taxpayers in those matters, unlike the present matter, failed to introduce any evidence into the record which established that they were the beneficial owners of the stock involved.

F. The petition of The Racal Corporation and Decca Electronics, Inc. is granted and the notices of deficiency dated June 15, 1989 are cancelled.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE